CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

COUNCIL AGENDA: 1.31.06
ITEM: 4.3

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Paul Krutko

SUBJECT: **AMERICAN AIRLINES ECONOMIC DEVELOPMENT AGREEMENT**

DATE: January 23, 2006

Approved [signature] Date 1/24/06

Council District: Citywide
SNI Area NA

RECOMMENDATION

Adoption of a resolution authorizing the City Manager to negotiate, enter into, and execute an Economic Development Agreement between the City and American Airlines and American Aviation Supply LLC which will provide for an economic incentive payment to American Airlines equal to a 65 percent of the sales taxes generated by its single source purchasing and resale company to be located in the City of San Jose over and above a base taxable sales for previous years.

These actions further the vision of San Jose as the world's most livable big city, with diverse and distinctive qualities of life and the City's economic development initiative to "Build a World-Class Airport Facility and Air Services (Economic Development Strategy Initiative 1) and Diversify San Jose's Economic Base and Preserve/Create Middle-Income Jobs (Economic Development Strategy Initiative 8).

BACKGROUND

American Airlines (American) a major existing employer providing air service critical to the economic health of San Jose and Silicon Valley is under severe pressure to reduce costs and is requesting assistance from the City in maintaining it operations in San Jose, Silicon Valley and the Bay Area. American has 337 employees and a $3.0M payroll in San Jose serving 60 daily departures from San Jose Mineta International Airport. This includes a key daily flight to Tokyo's Narita Airport – San Jose's only daily non-stop flight to the Far East, a region critical to the long-term economic health of San Jose.

American provides vital air service links that enable San Jose's major innovative companies such as Cisco Systems, IBM, eBay, BEA Systems, Cadence and Xilinx to conduct business and to operate global business operations from San Jose headquarters. Other leading companies such as Intel, AMD and Apple Computers that located in adjacent cities that provide significant employment to San Jose residents utilize these key air service links. The continuation of this air service is critical to health and long term economic development prospects of the City of San Jose by creating significant long-term revenue streams for necessary safety and other public services both directly from American's operations and the companies whose employees fly on the airline.

American Airlines has requested that the City consider a proposal to establish and maintain a wholly owned procurement entity, American Aviation Supply LLC (AAS) in San Jose in connection with a phased realignment of its procurement functions. The purpose of AAS would be to procure aviation fuel and other items through an office to be located in San Jose, making San Jose the locus for state and local sales tax collection on these purchases thereby giving the City of San Jose the full local allocation of the sales tax revenue (i.e., the 1% Bradley-Burns Uniform Local Sales and Use tax portion) from American Airlines' and American Eagle's (its regional affiliate) fuel and potentially other purchases in California.

American Airlines' request is based on the recent determination by the State of California Board of Equalization (SBE) allowing the continuation of a similar arrangement between United Airlines and the City of Oakland. American believes that the action by the SBE puts American Airlines and all other airlines operating in the State of California at a competitive disadvantage in that the United Airlines/City of Oakland partnership provides substantial sales and use tax expenditure savings to United Airlines. In exchange for establishing the single source purchasing entity for the State of California in Oakland, the City of Oakland makes an economic incentive payment to United Airlines equal to 65% of the local share of sales taxes attributable to California aviation fuel purchases and resales made by the purchasing entity throughout the State.

A key set of issues for Council consideration is that moving forward with this proposed agreement would seem to contradict the policy directive of the Council to oppose the United/Oakland agreement and to support legislation that banned and limited such arrangements.

A bill to ban such arrangements was passed in the last days of the 2004 legislative session but was subsequently vetoed by the Governor. AB 451 was introduced in the 2005 legislative session banning such arrangements as of January 2008 and that bill was approved by the Legislature and signed by the Governor – in effect allowing the Oakland/United deal to stay in effect for two more years. The San Jose City Council formally supported AB 451. San Mateo and the City of San Francisco then went to the State Board of Equalization to invalidate the Oakland/United deal. The SBE tax committee voted 3-2 to leave the Oakland/United deal in place with the majority stating that the Legislature had spoken on this matter. The record indicates that SBE members fully understood that other airlines would pursue similar agreements as a result of this action. The action by the United Airlines and City of Oakland is allowed under State law through December 31, 2007.

The policy choice faced by the City Council then is framed by the recent actions of the State Legislature and SBE. These actions have left in place a competitive advantage to United Airlines, the Oakland Airport and the City of Oakland. This in turn creates a competitive disadvantage for American Airlines, one of the two leading carriers at the San Jose Mineta International Airport and for all other airlines operating in the Bay Area and State of California as a whole because the United/Oakland agreement has ramifications on the sales tax paid on fuel across the entire state.

Given the action by the SBOE and the two-year period before the prohibitions of AB 451 take effect, American Airlines advised the City Administration that it cannot allow this competitive disadvantage and it will seek to enter into an agreement with a municipal government in California to level the playing field. It should be noted that the effect of the Oakland action has been to transfer local sales and use tax paid on fuel used by United Airlines at the Mineta San Jose International Airport from San Jose to Oakland where it is included in the calculation of the economic incentive payment that Oakland makes to United. If American and other airlines were to enter into similar agreements with other municipalities, the City of San Jose would stand to lose additional significant amounts of local sales and use taxes over the next two years.

The amount of local sales and use taxes paid by American can only be approximated for the purposes of this memo due to disclosure provisions of State law. Over the last few years the amount of California state and local sales and use taxes paid by American statewide on jet fuel has ranged from $20M to $40M+ with the increase significantly attributable to rising fuel costs. The relevant local (1% Bradley-Burns) share of sales and use taxes on jet fuel purchased by American has had an approximate range of $3M to $5M+ statewide (representing approx. 12% of the total combined state and local tax rate) with the City of San Jose's share ranging from $.4M to $.5M.

American Airlines in discussion with City staff indicated that it reached out to San Jose because of its strong relationship with the Airport and significant operational and economic presence in San Jose.

ANALYSIS

The proposed deal with American Airlines is fairly straightforward. The competitive advantage obtained by United Airlines with the procurement of jet fuel in Oakland will continue for two more years under AB 51 and by the determination of State Board of Equalization. American Airlines is seeking an agreement with the City of San Jose for the remainder of the two-year period.

The proposed agreement with American Airlines will be similar to the United Airlines-Oakland agreement. The proposed American Airlines/San Jose agreement would have a similar level of economic incentive payment equal to 65% of the local share of sales and use tax paid on fuel purchases and resales made by an American Airlines affiliated San Jose based purchasing company (American Aviation Supply LLC) for operations in the entire State of California. The amount of new tax revenue calculated for the incentive payment would be from the date the new purchasing company is located in San Jose, which would be January 2006. The San Jose agreement would differ from the Oakland agreement in that the 65% incentive payment does not apply to base level of sales and use tax currently paid by American Airlines and American Eagle Airlines, it regional affiliate, to the City of San Jose. The base level will be established by calculating an average of the actual amounts received by the City in the last three years (or some equivalent metric to target incremental local sales and use tax attributed to the American Aviation Supplies' activities in San Jose). Currently sales taxes on fuel purchases that ultimately are used by American and its affiliate American Eagle are paid directly to suppliers like BP and Chevron under contractual arrangements with American. The incentive payment would apply only to purchases of fuel by the American affiliated purchasing company for use by American Airlines, American Eagle and potentially others at California airports outside San Jose. American Airlines and American Eagle intend to assign existing fuel contracts to the purchasing entity in San Jose along with any new fuel contracts. The local purchasing entity would purchase fuel from suppliers (American currently buys approximately 1/3rd of its supplies from Chevron and 2/3rds from BP) for subsequent resale to American Airlines and American Eagle Airlines and potentially others. The sale by American Aviation Supply would be localized to its San Jose office and the additional Bradley-Burns local tax revenues would be allocated to the City.

The proposed San Jose/American Airlines agreement also provides for renewal options should the Legislature extend the allowable period for such arrangements under AB 451 beyond the end of 2007.

The proposed San Jose/American Airlines agreement also provides for a similar incentive payment for statewide purchases of other items such as equipment and supplies for which American is considering consolidating purchasing in connection with a broader realignment of its national purchasing function. These types of purchases are not impacted by AB 451. Consequently, the City could receive a greater share of local tax revenue for other products which otherwise would have been realized by other local jurisdictions.

Under current state law and regulations of the State Board of Equalization if a retail entity such as contemplated in this recommendation has only one place of business in the State of California, then all California retail sales of that retailer are deemed to occur at the place of business of the retailer regardless of where in the state the personal property sold is delivered. The local 1% sales tax collected on such sales is remitted to the city in which the retailer's single place of business is located. The single place of business would be the City of San Jose under this proposal.

OUTCOME

The outcome of this agreement is that the City of San Jose will realize significant one-time sales and use tax revenues over the next three fiscal years and possibly beyond. As an example, if $5M was paid in local sales and use tax across California by American Airlines (assuming that current local sales tax revenue attributable to American Airlines' purchases at Mineta is $500,000), the City would receive approximately $1.6M ($5M - $500,000) X .35 = $1.575M.

From this example, this action would also protect the City from a potential loss of sales and use tax of $500,000 per year if American Airlines decided to enter into a similar agreement with another jurisdiction in California. It also creates a framework to have American Airlines make a broader range of procurements through a San Jose based procurement company beyond airline fuel that are not impacted by the action of the State Legislature. An expanded procurement structure will facilitate American's national objective to have greater cost visibility and direct tax determination control over spending on equipment and supplies for budgeting and cash management purposes.

It should be noted that other airlines operating in the State of California might seek similar arrangements with other cities. The staff of the Office of Economic Development is reaching out to other airlines to determine whether they would be interested in entering into an agreement similar to what is being recommended in this action with American Airlines.

COORDINATION

This memorandum has been coordinated with the Departments of Airport and Finance, the Budget Office and the City Attorney's Office.

COST IMPLICATIONS

As noted above, this agreement could realize the City approximately $3M in one-time sales and tax revenue over the next three fiscal years. Failure to enter into this agreement could subject the City to the loss of $1M in existing sales and tax revenue over the next three fiscal years.

CEQA

Exempt.

Paul Krutko

PAUL KRUTKO
Director, Office of Economic Development